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Mayor C. Nelson Harris
Vice-Mayor Beverly T. Fitzpatrick, Jr.
Alfred T. Dowe, Jr.
Sherman P. Lea
Brenda L. McDaniel
Brian J. Wishneff

Dear Honorable Members of the Audit Committee:

As was discussed at the Audit Committee meeting on April 4th, we evaluated the <u>system</u> of internal controls in place in the Commissioner of the Revenue's office that is relied upon to ensure personal property and business license taxes are assessed in accordance with the law. Government Auditing Standards, issued by the U.S. Comptroller's Office, specify that the system of internal controls includes the plan of organization, methods, and procedures adopted by management to meet its mission, goals, and objectives. Internal control includes the processes for planning, organizing, directing, and controlling program operations. It includes the systems for measuring, reporting, and monitoring program performance. Government Auditing Standards require that we consider the <u>system</u> of internal controls because the lack in administrative continuity in government units, changes in elected legislative bodies, and changes in other government officials increases the need for an effective, well-established system of internal controls. Our audit of the Commissioner's office was consistent with the work we perform in all departments and offices in the City and Schools. Our discussions with the Commissioner and his staff throughout the audit consistently addressed our concerns regarding documented policies and procedures, processes that address risks of noncompliance, and business planning.

The Commissioner has noted that his office was audited by the Department of Taxation and had "outstanding and exceptional" results. The Department of Taxation's audit addresses the Commissioner's responsibility for qualifying vehicles for tax relief. In simple terms, the audit is designed to ensure the Commissioner does not qualify vehicles for tax relief that do not meet the program criteria, thus ensuring that the State does not remit more revenue to the City than required under the program. The results of the audit indicate that the State is satisfied that it is not being overcharged by the City. On the other hand, the Department of Taxation's audit does not address questions regarding the completeness of the personal property records and whether or not the City has reported all qualifying vehicles garaged in the city. The Department of Taxation's audit does not address whether or not the City has received its fair share of tax relief reimbursement.

The Commissioner also indicated that no instances of noncompliance were noted in the most recent annual audit conducted by KPMG. The KPMG report in question relates to the procedures mandated by the Virginia Auditor of Public Accounts [APA]. These procedures include tracing assessments made by the Commissioner's office into the Treasurer's billing and accounts receivable records to ensure what is assessed is billed. The procedures also include verifying that the Commissioner's office correctly entered those values set by the State Corporation Commission for assets of public service companies. The procedures also include verifying approval for exonerations, verifying the Treasurer has properly recorded exonerations, verifying that special levies were disbursed to the proper funds, and sending confirmations for delinquent taxes. Specific procedures related to the Personal Property Tax Relief Act (PPTRA) include verifying the proper qualification of vehicles for PPTRA, verifying that the proper amount of relief was calculated, and verifying that over/under payments were properly resolved by the Treasurer. The Municipal Auditing department is well versed in these procedures, as it was our staff that performed this audit work in the Commissioner's office for the last two years under KPMG's supervision and review. These procedures do not address the completeness of the tax assessments or their accuracy. As you consider these procedures, you will notice that both the APA and the Department of Taxation exclusively address the interests of the State and provide little assurance that local taxes are effectively and appropriately assessed.

In regards to local taxes, specifically business license and business personal property, the Commissioner indicates that his office is "auditing" 62% of business license accounts and 39% of business personal property accounts. Two questions must be asked to understand the meaning of these numbers: the first question is how are we defining "audit," the second is what are the tangible results of these audits. Our review of the business license audit function indicates that the majority of the "audits" conducted by the business license staff are in-office desk <u>reviews</u>. These reviews include looking at state sales tax reports and Schedule C from personal tax returns. These sources of information exclude service based corporations which are a significant segment of taxpayers. Also, some large corporations do not report their sales tax under a single locality code, making it more difficult to develop any substantive determinations using the sales tax report. The review of business personal property is limited to comparing prior years' values to current year values on a report or as they are being input, and to reviewing the zero balance report to identify non-filers. As we noted in our audit report, even in those instances when the Commissioner's office identified non-filers, there is inadequate follow up. We noted that 963 notices were mailed to non-filers in 2004 with only 265 businesses responding to those notices. Those businesses that did not respond to the letters were not contacted, were not audited, and were <u>not statutorily assessed</u> as is required by law. Again, we must emphasize that there are no audit programs used by the Commissioner's office, no analytics commonly prepared by the office, and no program of planned field audits.

The Commissioner stated that 50 field inspections were conducted for business license tax. These include cigarette inspections, manufacturer certification for exemption of business license tax, and inspections of transient businesses operating in the City. An example of a transient business that the Chief Deputy recited to me was the person selling mattresses out of the back of his van. If a citizen complains, the Business License Inspector has to go out into the field to investigate. These field inspections are not comprehensive audits of business records that have an objective of verifying the accuracy of gross receipts or business personal property filed. Based on the records provided to our staff during the audit, tax compliance efforts in business personal property only yielded an average of $41,376/year in net levy from 2002 -2004 though the total business personal property levy over that period was approximately $11.5 million. Expenditure records for the Commissioner's office indicate that no local mileage was paid to the Tax Compliance Auditor for business personal property in fiscal year 2003 and 2004. The Business License Inspector only claimed $42 in 2003 and $64 in 2004 for local mileage. We believe this supports our conclusion that very limited audit work has been conducted in the field by the Commissioner's staff. As we noted in our original report, well planned and targeted field audits are the most effective means to ensure compliance. The best means of verifying the accuracy of a return is to observe the equipment and the books at the business.

The Commissioner also stated that 309 real estate agent accounts were reviewed. This refers to the listing of active agents the Business License Inspector requests from real estate offices each year. He compares the listings to the agents who have filed with the Commissioner. The license is a $15 flat fee per real estate agent in the City – an audit of $4,635 in total levy, yet the total business license levy is approximately $11.3 million. Again, we have recommended that the Commissioner's office prioritize enforcement efforts to address the City's most significant exposures to under reporting rather than doing those things that are easiest to do.

In closing, I want to be clear that our evaluation of the Commissioner's office was consistent with recognized standards for conducting audits and with the audits we have conducted in all other city departments. We would welcome any member of the Audit Committee or the public to review our work papers and make your own conclusions. I would hope that it is readily apparent that the recommendations we have made are reasonable and prudent, being that they are based on recognized practices promoted by Commissioners' offices throughout the State of Virginia. To suggest that our recommendations endorse a harassing and threatening approach to administering the tax code is beyond rational reasoning. To suggest that a professionally and competently administered program of tax compliance auditing is a disservice to honest tax payers is in my opinion indicative of someone who has failed to comprehend the crucially important responsibilities assigned to the Commissioner's office under the State Constitution and the Code of Virginia.

Respectfully yours,

Drew Harmon, CPA, CIA
Municipal Auditor

c: Darlene L. Burcham, City Manager
Jesse A. Hall, Director of Finance
William M. Hackworth, City Attorney
Sherman A. Holland, Commissioner of Revenue
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